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Attention G-7 Leaders: Investment Taxes Can Harm Your Nations' Health

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In the past decade, many countries around the world began to shift taxes away from capital and onto less mobile tax bases. As a result, the G-7 nations now face pressure to act decisively to restructure their tax systems as well. Clearly, a dose of pro-growth tax reform would give a healthy boost to the world's leading economies and, in a world that is dependent on trade and global capital flows, to other nations as well.

For his part, President George W. Bush appointed an expert panel to propose a simplified growth-promoting tax structure. That panel will report soon, and its findings will spark a major debate in the U.S. and elsewhere on the advantages of redirecting taxes from income toward consumption.

The governments of the industrialized nations raise, as they must, hefty revenues to fund public services. At the top of the league in that regard is Sweden, where the government's take from tax and non-tax revenues, such as user fees, resource royalties and profits from state-owned enterprises amounts to 60 percent of gross domestic product (GDP). At the lower end of the spectrum is deficit-laden Japan, whose revenues are less than 30 percent of GDP. The larger countries — the United States, Britain, Canada and Germany — raise less revenue as a share of GDP than do many smaller ones. By this measure, the larger economies look competitive, but only if seen through the wrong end of the telescope.

Measure for Measure

An aggregate measure that simply adds up income, sales, payroll, property taxes and other revenues and divides the number by GDP does not tell the real story of taxes and the economy. That is because some taxes have more harmful effects than others. Economic studies show that personal and corporate taxes with high marginal rates are much more harmful to growth than levies on consumption and immobile assets such as land.

Heavy taxes on investment discourage businesses from buying the new-vintage capital and latest technologies that improve labour productivity. In the absence of

such modernization, production processes age, businesses fall behind and they have difficulty increasing their employees' incomes. Such is the case in Canada, where annual business investment per worker has dropped by nearly a fifth in recent years and productivity and wage growth have languished. This decline has taken place in the face of research showing that lowering or eliminating income taxes on investment can lead to potentially large economic gains. In fact, a 2001 study by economists Dale W. Jorgenson and Kun-Young Yun suggested that replacing federal, state and local personal and corporate income taxes in the United States with a flat tax that excluded investment income would create an economic gain of over $2 trillion.

Indeed, lowering taxes on capital investment holds the key to growth. To gauge the impact of taxes on investment, it is essential to look beyond the corporate income tax rate that applies to profits — 35 percent in the United States or 12.5 percent in Ireland, for example — and consider effective tax rates. Effective rates diverge because governments use different rules for depreciation, inventory costs and other business expenditures. When governments allow accelerated depreciation, for instance, the effective tax rate is less than the statutory one. Moreover, many countries levy other types of taxes on business investments, including sales taxes on investments in machinery (as under China's 17 percent value added tax, or VAT), gross or net worth taxes in Canada and Mexico, or financial transaction taxes.

Taking into account corporate income taxes and the other levies related to capital investment, we have estimated the effective corporate tax rate on capital investment for large businesses operating in 36 industrialized and leading developing countries. The effective rate is the amount of tax paid as a percentage of the pretax inflation-adjusted and risk-adjusted rate of return on capital that is sufficient to cover the costs of financing in international markets. Our estimate is based on the proposition that businesses invest in capital as long as their profit covers their financing costs. For example, if a business earns a pre-tax yield on investments equal to 9 percent and if, after taxes, a 5 percent rate of return on capital is demanded by investors, the effective tax rate is [9 – 5] ÷ 9, or 44 percent.

When it comes to taxing capital investment, the G-7 countries and three large developing ones — China, Brazil and Russia — impose the greatest burdens (see Table 1). The high effective tax rate on capital investments in China (46 percent) results from the 17 percent VAT on machinery, which may, however, be reduced by negotiation with investors. If a full refund were given to businesses for VAT on machinery purchases, the effective tax rate on capital in China would drop to 17 percent. Canada, at 39 percent, has the second-highest effective tax rate on capital investment, mostly because of high provincial capital and sales taxes on capital inputs. The third-highest rate is in Brazil, reflecting its relatively high inflation rate and sales taxes on capital inputs. The U.S. has the fourth-highest rate, resulting from a statutory corporate income tax rate that is high by international standards, as well as substantial state retail sales taxes on capital investments.

Where the Money Goes

The most favourable tax regimes for investment are in Hong Kong, Ireland, Iceland, Singapore, Slovakia and, perhaps surprisingly, Sweden. These countries'

Table 1: *Effective Tax Rates on Capital for Large and Medium-Sized Corporations, by Country, 2005 (percentages)*

		Effective Tax Rates		
	Statutory Corporate Income Tax Rate	Manufacturing	Services	Average
China	24.0	45.5	46.5	45.8
Canada	34.3	35.5	41.3	39.0
Brazil	34.0	40.1	37.2	38.5
U.S.	39.2	34.6	40.0	37.7
Germany	38.4	37.7	36.3	36.9
Italy	39.4	33.3	38.1	36.2
Russia	22.0	35.0	34.1	34.5
Japan	41.9	34.4	33.1	33.6
France	35.4	33.3	33.4	33.3
Korea	27.5	31.9	29.6	30.8
New Zealand	33.0	30.1	28.8	29.3
Greece	32.0	33.0	27.8	29.3
Spain	35.0	29.9	25.8	27.3
Norway	28.0	26.1	24.7	25.1
Netherlands	31.5	25.3	24.9	25.0
India	33.0	23.2	24.9	24.3
Australia	30.0	29.4	22.1	24.1
Finland	26.0	23.5	22.4	22.9
Luxembourg	30.4	21.4	22.1	21.9
U.K.	30.0	22.7	21.2	21.7
Belgium	34.0	21.4	21.3	21.4
Poland	19.0	20.6	20.0	20.2
Denmark	30.0	20.6	19.4	19.8
Austria	25.0	20.3	18.8	19.4
Hungary	16.0	18.8	17.7	18.2
Czech Republic	26.0	21.3	14.0	17.7
Switzerland	22.0	16.9	17.1	17.0
Mexico	30.0	17.2	16.4	16.7
Ireland	12.5	14.1	13.2	13.7
Portugal	27.5	11.7	14.6	13.5
Sweden	28.0	12.8	11.6	12.1
Iceland	18.0	13.1	11.6	12.1
Slovak Republic	19.0	9.6	8.7	9.1
Hong Kong SAR	17.5	6.1	8.3	8.1
Turkey	30.0	7.3	5.7	6.4
Singapore	20.0	5.8	6.6	6.2

Source: C.D. Howe Institute.

corporate income tax rates are low, and in the case of Sweden, businesses are allowed fast write-offs for capital investment.

Low effective tax rates on capital attract foreign direct investment, which, as a share of GDP, is relatively high in Ireland (18.2 percent), Singapore (14.1 percent), Hong Kong (15.2 percent) and Sweden (8.2 percent). This compares favourably to Canada and Germany, for example, where foreign direct investment is 3.8 and 2.7 percent of GDP.[1]

Because of the high effective tax rates on capital in G-7 countries, it is clear that the largest industrialized economies face an urgent problem as they compete for capital investment, which increasingly flows to Asia to take advantage of that region's low-cost, efficient labour. As a first step, G-7 nations must reform their income tax systems by lightening levies on investment income. Indeed, they have little choice but to rise to the challenge by restructuring their tax systems to attract investment capital and increase savings. The alternative is not pretty: Investment will dry up, jobs will disappear and the locus of power and influence will shift to other, more welcoming national hosts.

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1 World Bank investment figures for the 1997-to-2003 period.

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